**Before the**
**FEDERAL COMMUNICATIONS COMMISSION**
**Washington, DC 20554**



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| In the Matter of | ) | |
| | ) | |
| Implementations of the | ) | CC Docket No. 96-128 |
| Pay Telephone Reclassification | ) | |
| and Compensation Provisions of | ) | DA 98-1198 |
| the Telecommunications Act of | ) | |
| 1996 | ) | |
| | ) | |

# COMMENTS

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Dated: July 13, 1998

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## COMMENTS

MCI Telecommunications Corporation (MCI) hereby comments on the Public Notice released June 19, 1998,[1] in which the Commission requests comments on the issues remanded by the Court in the payphone proceeding.

In MCI v. FCC,[2] the Court concluded, for the second time, that the Commission failed to explain why a market-based rate for coinless calls could be derived from a market rate charged for coin calls. In rejecting the Commission's approach, the Court found that the Commission did not demonstrate that costs and rates do in fact converge in the coin call market. To address the Court's concerns, the Commission asks for comments on the nature and degree of competition in the payphone industry since the deregulation of payphones, including whether and the extent to which costs and rates converge in the coin call market; similarities and differences between the market segments for coin and coinless calls; and the reasonableness of adjusting the local coin rate

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[1] Public Notice, CC Docket No. 96-128, DA 98-1198, released June 19, 1998.

[2] MCI v. FCC, No. 97-1675, slip op. (D.C. Cir. May 15, 1998).

for cost differences between providing coin and coinless calls as a market-based mechanism for deriving fair compensation for coinless calls.

## I. COMPETITION IN THE PAYPHONE MARKET

Competition, where multiple firms or individuals compete for consumers to buy their product or service, has been recognized as a superior alternative to regulation at producing desirable market performance measures such as prices near the long-run cost of production, increased quality, and product innovation. When there is such "competition-within-the-field" all profits above normal profits are competed away, thus ensuring reasonable rates to consumers. Such competition promotes the public interest-- but it is not present in the payphone market.

"Competition" in the payphone marketplace is between payphone service providers (PSPs) to be selected by the location provider as the provider of payphones on the premise. PSPs "compete" for this ability by promising to pay the highest commission to the premise owner. As demonstrated in the attached economic analysis of the payphone market prepared by the E GROUP,[3] this "competition-for-the-field" is "a competitive process whereby the 'winner' obtains the exclusive monopoly right... to serve a market."[4] Because the "competition" is for the exclusive right to serve a payphone site, payphone operators are required to operate in a monopoly fashion in order to generate incomes sufficient to win franchises from site owners by offering the highest "bid"-- the largest commission. This process necessarily renders a price that equals not the cost of production, but "the monopoly price wherein sellers capture the monopoly

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[3] See, the E GROUP Study at Exhibit 1.

[4] E GROUP Study at 2.

rent from consumers."[5] Thus, because of the interaction of location monopoly at payphone sites and the ability of premise owners to "auction off" the right to serve that monopoly, competition in the payphone marketplace creates an incentive for the PSP to raise rates, including the local coin rate, rather than lower rates under the constraint of competitive forces, to be able to make higher commission payments to the location provider. Accordingly, the payphone market lacks the characteristics of competition that drive rates to costs[6] and, therefore, the market forces in the payphone marketplace do not lead to "competitive prices."

The E GROUP's conclusion that payphone sites are locational monopolies is supported by its findings concerning the effects of competition on location commissions and payphone coin rates-- namely, that competition for site locations is driving up commissions and, as a consequence, coin rates-- and its analysis that wireless services and other payphone locations are poor substitutes for a specific payphone's services. According to the E GROUP, the mere fact that some LECs have increased local coin rates by forty-percent since the deregulation of those rates-- from 25 cents to 35 cents-- in a number of existing (and, thus, already profitable) payphone locations, indicates that individual payphone sites are locational monopolies. In addition, the LECs' own statements -- that they have increased their payphone coin rates to pay competitive commissions to property owners[7]-- demonstrates that payphones are locational monopolies and that competition, or the lack thereof, cannot be relied on to keep prices in line with economic costs. Further, payphones are locational monopolies when analyzed in the context of the

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[5] Id.

[6] Id. at 11.

[7] Id. at 6.

Department of Justice's Merger Guidelines because there is no product of sufficient substitutability-- not cellular phones and not even nearby payphones-- to constrain price increases.[8]

## II. ECONOMIC COSTS AND RATES DO NOT CONVERGE IN THE COIN CALL MARKET

Because payphones are locational monopolies, economic cost and rates do not and will not converge. Rather, local coin rates will include monopoly rent for the location.[9] Although monopoly rent is an expense to payphone providers, it should not be considered in determining whether costs and rates converge because it reflects a cost that would not occur in a competitive market in which locations accommodated multiple PSPs that competed for the patronage of consumers.[10]

Since regulators should seek to implement prices that equal those expected under competitive conditions, location rents also should not be considered in setting a default compensation rate. The locational rent (commission) is not an economic cost, but a transfer payment equal to the monopoly profit. Also, because there is free entry into the market to compete for payphone locations, the monopoly rents accrue totally to the location owners in the long run. Therefore, contrary to the conclusion of the Commission, more compensation to the

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[8] Id. at 8-10.

[9] Id. at 15.

[10] Id.

PSP will not significantly increase the number of payphones. It will only increase the rents paid to location owners, resulting in a substantial loss of consumer welfare.[11]

In addition, because the rate for local coin calls must be rounded to the nearest coin denomination that the payphone accepts and because payphones do not render change, rates in the local coin market will not accurately reflect the cost of such calls. MCI is not aware of any payphones that accept coins less than a nickel and, in fact, certain payphones only accept quarters. Thus, even if the local coin market otherwise functioned perfectly, if the rate at which that market would come to rest is a rate ending in 1 through 4, the coin rate could not equal the cost.

## III. THE MARKET SEGMENTS FOR COIN AND COINLESS CALLS ARE DIFFERENT

Local coin calls are different from access code and subscriber 800 calls in ways that preclude market substitution. Most notably, the buyers in the two markets are entirely different. In the local coin market, the "buyer" is the party placing the call, and the "seller" is the PSP. The seller sets the coin-call price at its payphones and the buyer decides, before purchasing that service and at the point-of-sale, whether to make the call at the price the PSP offers.

By contrast, a caller placing subscriber 800 calls or access code calls is not a "buyer" at the point-of-sale and may not be a "buyer" at all. Although the payphone user decides if and when an 800 or access code call is placed, the true "buyer"-- the party responsible for paying the cost of using the payphone and the cost of the call--is either the carrier that carries the call or the customer who ultimately pays for the call. For an 800 call, the customer who pays for the call is

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[11] Id. at 14.

the 800 subscriber. For an access code call, the customer could ultimately be the caller, but not necessarily.

The difference is significant. Because the caller does not pay for the call at the point-of-sale, the caller has no incentive to make calls only from low-cost payphones, or when prices are set below a certain level. Indeed, in most cases the caller has substantially reduced incentives, as well as a lack of information necessary, to make an economically efficient decision, no matter how high the compensation rate for the call. Further, the coin market is driven by consumers who pay "over and above normal charges, for the convenience of the payphone." Because 800 subscribers in most instances have no interest in the convenience of payphones, they would be less willing to pay the premium that callers might be willing to pay.

## IV. IT IS NOT REASONABLE TO ADJUST THE LOCAL COIN RATE FOR COST DIFFERENCES BETWEEN PROVIDING COIN AND COINLESS CALLS AS A MARKET-BASED MECHANISM FOR DERIVING FAIR COMPENSATION FOR COINLESS CALLS.

Because of the distinctions between the coin and coinless call markets and the circumstances which preclude the convergence of local coin rates and cost which are discussed in Section II., the rate for a coin call cannot be used as the starting point for the cost of a coinless call. Rather, the default compensation rate for subscriber 800 and access code calls should be determined using a cost-based approach that relies on costs and quantities that are consistent with a market where multiple firms actively compete for the patronage of consumers. Once implemented, a cost-based compensation mechanism would not need to be continuously recalculated, and, thus, should not be administratively burdensome, because most payphone costs

do not vary based on usage and the number of calls from payphones is increasing. Accordingly, if anything, the cost per call should decrease.

MCI has prepared a cost study,[12] which calculates the entire cost to provide an additional payphone, including usage costs associated with an average number of coin and coinless calls. As discussed in the E GROUP Study, a payphone cost study should include the following underlying economic principles: the minimum economic cost of a payphone capable of providing both dial around and coin calls should be calculated; all costs attributable to coin capability, including costs of the coin equipment, coin collection, vandalism and theft prevention measures, should be subtracted; the opportunity cost, if non-zero, of the physical space required for the payphone should be added;[13] the competitive prices of coin calls and coinless calls should be calculated and the average quantities of usage associated with these competitive prices (and not the observed monopoly prices) should be calculated; and joint and common costs between coin and coinless calls should be allocated based on the estimated competitive quantities of these calls. The MCI study, which is based on these principles, demonstrates that the cost of a coin call is between $0.11 and $0.16 per call and the cost of a non-coin call is between $0.08 and $0.12 cents per call.

The study is based on publicly available data on investment and other costs incurred by PSPs. All supporting documentation for the cost inputs is included and all assumptions made in the study are identified. In many instances, the inputs and methodology are overly conservative.

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[12] See, MCI Payphone Cost Study at Exhibit 2.

[13] Such opportunity cost usually would be zero and it might be negative if a location owner's other business benefits from having a nearby payphone.

It is worth noting that the results of MCI's cost study are in line with other publicly available data and the cost data already on the record in this proceeding. For example, the MCI cost study develops an average cost of installing a new smart payphone of $1,650 including station investment and labor, whereas in its 10-K report, People's Telephone estimates $1, 950 as "the average cost of installing a new payphone, including site selection, hardware and labor." [14] People's slightly higher number can be explained by a number of variables, such as People's may have a richer mix of payphone stations and enclosures than that assumed by MCI. In any event, the $300 difference per payphone increases the total cost per call per month by only $0.02. In addition, MCI's per call results are in line with the finding of the Massachusetts Department of Public Utilities that the cost of a local coin call for New England Telephone is approximately $0.17. Accordingly, MCI believes that its cost study accurately reflects the cost of a non-coin call and should be used to determine the default compensation rate.

## V. CONCLUSION

The foregoing demonstrates that local coin rates and costs will not converge in the payphone market and, therefore, the Commission cannot devise a market-based rate for coinless calls based on the observed rate for coin calls. Accordingly, a carrier-pays compensation

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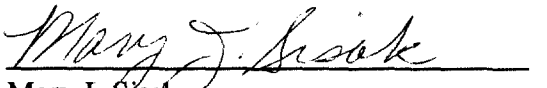
[14] People's Telephone 10-K report at 9.

mechanism must be based on economic cost. Further, as demonstrated, a cost-based compensation mechanism should be based on the cost study submitted by MCI in this proceeding.

Respectfully submitted,

MCI Telecommunications Corporation

By: 

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Dated: July 13, 1998

**EXHIBIT 1**

# A Study of Payphone Market Organization and Compensation

*T. Randolph Beard III, Robert B. Ekelund Jr., and Richard P. Saba*[*]

*The 1996 law did produce one change: higher pay telephone rates.*[1]

## I. Introduction

Competition affects nearly every aspect of human life -- from the evolution of our species, the games we play, to the goods and services we buy and sell. Competition, in every case, is simply about the pursuit of a prize, whether that prize is a trophy or a customer's patronage. In markets, we associate competition with lower prices, higher quality, increased innovation, or some mixture thereof. These desirable outcomes arise when multiple firms vie for the patronage of consumers; their self-interested motivations are led by an "invisible hand" to the satisfaction of consumer desires, the minimization of costs, and the maximization of social welfare. These welcome market outcomes do not emerge, however, when consumer choice among suppliers is substantially restricted or altogether eliminated thereby creating monopoly, the antithesis of competition.

The concept of market competition is not limited, however, to situations of multiple firms vying for the patronage of consumers. For example, the auction of a unique object, say a Picasso painting, involves competition among multiple bidders. This competition, rather than insuring the customer purchases the object at the lowest price possible, forces price up and renders to the seller the full "monopoly" value of the object.[2] Likewise, the process of granting monopoly cable television franchises can lead to higher prices for consumers if franchise authorities extract the monopoly rent, in whole or in part, through various

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[*] E Group, Economic and Econometric Research Consultants, 404 Blake Street, Auburn, Alabama 36830, (334) 821-1404, (334) 844-4615 fax. Report Completed: Monday, July 13, 1998.

[1] Year in Review, Patriot Ledger, December 31, 1997.

[2] In the FCC's auctions of spectrum, the agency typically offers multiple licenses for the same geographic area to ensure multi-firm supply and, as a consequence, welfare improving competition.

franchise requirements or political side-payments.[3] Theoretically, if the goal of the franchise authority were to maximize the payoff received from the "auction" of the cable television franchise, then the franchise authority would allow only one winner and use the competition among bidders as a mechanism to more accurately determine the maximum payoff, i.e., the monopoly profit.[4]

One useful way to characterize the results of these two notions of competition, one producing the competitive price and the other the monopoly price, was offered by economist Edwin Chadwick in 1859 where Chadwick differentiated between "competition-*within*-the-field" and "competition-*for*-the-field."[5] *Competition-within-the-field* is simply that condition of multiple firms or individuals competing for consumers to buy their product or service. The best example is the textbook model of perfect competition where price equals the long run marginal costs of production in long run equilibrium.[6] *Competition-for-the-field* is a competitive process whereby the "winner" obtains the *exclusive* monopoly right, perhaps by auction, to serve a market. This competitive process may render an equilibrium price that approximates the competitive price wherein price equals costs of production or, in contrast, the monopoly price wherein sellers capture the monopoly rent from consumers. Generally speaking, Chadwick's distinction suggests that in the evaluation of competition, one must consider the nature of the winner's purse, i.e., are firms competing among

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[3] See R. B. Ekelund, Jr. and Donald J. Boudreaux, "The Cable Consumer Protection and Competition Act of 1992: The Triumph of Private over Public Interest," University of Alabama Law Review (Winter 1993), pp. 355-391 and Thomas W. Hazlett, "The Demand to Regulate Franchise Monopoly: Evidence from CATV Rate Deregulation in California," Economic Inquiry, Vol. 29 (1991).

[4] See, e.g., Daniel F. Spulber, Regulation and Markets, Cambridge: The MIT Press, 1989, pp. 93-99.

[5] The franchise-bidding proposal as an alternative to government operation or regulation is an ancient idea. Monarchs often used this concept to supplement taxes. The process was simple. The ruler claimed regalian rights, that is, absolute property rights, to provide a good or service. He or she then granted exclusive rights to the individual or individuals that paid the highest rent. With enough competitors, the monarch was able to extract the maximum monopoly rent from the process. This process -- long known to monarchs and dictators as a manner of generating revenues -- is not in any way equivalent to the modern standard notion of competition. One important modern incarnation of the idea is contained in Harold Demsetz, "Why Regulate Utilities," Journal of Law and Economics, Vol. 11 (1968), pp. 55-65.

[6] It is quite possible for a perfectly competitive firm to make a profit in the short run. In the long -run all profits above normal profits to the entrepreneur are competed away by the action of competitors who enter or exit the business. Prices are, in this manner, driven to long-run average costs of production.

themselves for the patronage of consumers or for the sole right to provide a good or service with few if any substitutes?

## 1. THE NATURE OF COMPETITION IN THE PAYPHONE INDUSTRY

It is our intent to show, and we believe the evidence supports, the notion that competition in the payphone industry is more akin to competition-for-the-field than competition-within-the-field. Payphone operators are characterized as competitors in a bidding war for the exclusive right to provide payphone service at a particular location. Premise owners reap the benefits of competition in the bidding process, securing the monopoly rent from the winning payphone operator.

Since competition-within-the-field is simply the traditional notion of competition with the desirable efficiency properties, we presume that the reader is familiar enough with this concept that further elaboration is unnecessary. Alternatively, competition-for-the-field is a less familiar concept, so some elaboration is justified.

### *Competition-for-the-Field*

A common form of competition-for-the-field is monopoly franchising, such as the competition that occurs for a monopoly cable franchise, municipal water provision, ambulance service, or payphone locations. In the case of monopoly franchising for the *public interest*, the general approach of municipalities is to set guidelines or specifications that the winning firm must meet. The winner in this type of franchise process is the firm that bids the *lowest* price for the specified quantity and quality of service. When the low bidder wins, prices are, at least under certain conditions, expected to approximate the cost of producing the good or service, i.e., the competitive price. When the low bidder wins a franchise auction, the owner of the monopoly right foregoes the monopoly profit associated with the right to provide service. Pursuing a franchise scheme that maximizes social welfare at the expense of monopoly profit might be expected, though not guaranteed, from governmental agencies providing "public goods."

Choosing to forego the monopoly profit from the "sale" of a property or right is a choice that should not be expected from self interested, profit maximizing

premise owners.[7] In contrast to the above example, if the seller of a property or right chooses to act in a self interested, profit maximizing manner, an entirely different result is obtained from the "competitive" auction process. The exclusive right to serve in this case will be given to the competitor offering the seller the *highest* monetary bid. The highest bid will equal the monopoly profit.[8] Thus, while the winning bidder will receive an exclusive right to serve the market, it will have paid the entire monopoly rent to the resource owner for that right. The winning bidder looks remarkably like a firm in a perfectly competitive industry - it has zero economic profit. Furthermore, it is in the interest of the resource owner to allow free entry into the bidding process, another characteristic of competitive markets. However, in contrast to the assertions of the Commission and the payphone industry,[9] the desirable outcomes of the competitive model do not prevail; *rather, the price and output in the market will equal monopoly, not competitive, levels.*

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[7] "I have never found a site owner who wasn't motivated to some extent by the possibility of earning higher commissions (The Guide to Payphone Ownership, Madison: Payphones Plus, 1996, p. 57)."

[8] Since the monopoly profit is the largest possible profit obtainable from the sale of a good or service, the highest bid will equal the monopoly value of the resource. This payment of monopoly rent is an out of pocket expense to the firm, but is a monopoly payment for the use of particular locations with the associated inferior consumer and total welfare properties. The better the locations (and the higher the probabilities of revenues), the higher the monopoly rent will be. That location rent is, of course, passed on to consumers in the form of higher prices.

[9] Second Report and Order, In the Matter of Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996, October 9, 1997, at ¶ 10 and ¶ 27 (*Second Order*). In an especially odd determination regarding competition in the payphone industry, the Iowa Commission's deregulation of payphones in 1985 was based on evidence that showed "customers desiring to acquire a pay telephone device have a choice among providers (In Re: Investigation into Competition in Communications Services and Facilities, Docket No. INU-94-5, February 21, 1985, p. 4)." No logic, however, is provided in explaining how a payphone operator or premise owner's ability to purchase a "pay telephone device" will insure "the service provided to the public by a pay phone will become competitive (p. 5)." The Commission's decision is akin to concluding that because households are no longer required to lease telephones from the local exchange carrier and can purchase their own telephones (CPE) from many sources and suppliers, the local exchange market is competitive.

The difference between the market outcomes of these two notions of competition can be illustrated by a simple figure. In Figure I, the market demand curve for payphone service at a specific location is labeled D and its associated marginal revenue curve MR. Assume, for illustrative purposes, that payphone service is produced at a constant marginal social cost MC = AC.[10] Marginal social cost, which under constant cost conditions equals average social costs, reflects the full value of resources to society *and no more*. Competition-within-the-field for payphone service will result in an equilibrium price and quantity of $P_c$, $Q_c$, respectively. Price equals marginal cost and each of the competing firms serving the market will earn zero economic profit (price equals average cost).

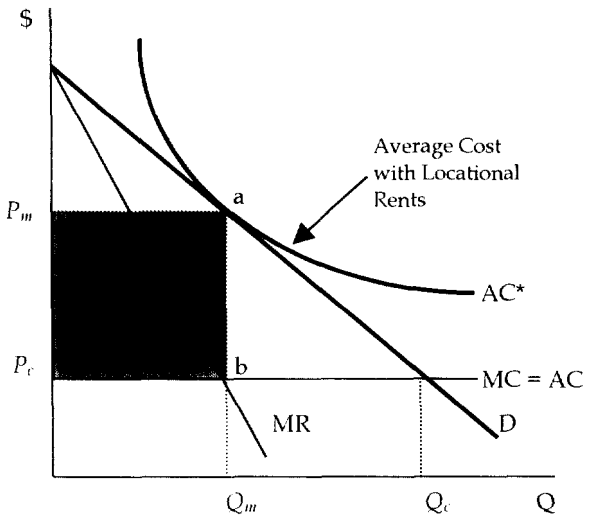


Figure I.

Competition-for-the-field can result in (at least) two outcomes. If the monopoly right to serve the market (represented by demand curve D) is granted to the firm offering to do so at the lowest price, the competition among bidders ensures that the competitive price and quantity ($P_c$, $Q_c$) will result. The location provider receives no profit, i.e., commission. Alternatively, the location provider can use the competitive process to secure for itself the monopoly profit. By offering the exclusive right to serve the market to the bidder offering the largest payment (or, in practice, the largest commission rate), the competition among bidders ensures the monopoly rent is offered. The monopoly price ($P_m$) obtains, producing a payment, or "commission," in the amount of $P_m abP_c$ (the shaded area of Figure I). This payment is a fixed (not a marginal) cost to the winning bidder, and equals the fully capitalized (monopoly) value of the location to the provider and firms. By offering the fixed payment, the payphone operator faces the average cost curve AC*, which reflects this fixed rent at every level of service. The price that results, $P_m$, for payphone services contains the monopoly rent

[10] We are not implying that the payphone industry is characterized by constant marginal and average cost. The assumption of constant cost is solely for the purpose of simplifying the graphical analysis.

although each payphone firm will earn a zero economic profit. The transfer from the payphone operator to the premise owner is not observed directly by the consumer, but indirectly in the *monopoly price* for payphone service. As we will discuss later, the fact that the monopoly quantity $Q_m$ is less than the competitive quantity $Q_c$, and that observed quantities will be associated with a certain price, is important in the determination of the per-call coinless compensation rate.

*Evidence*

Whether the competitive or monopoly price prevails, both processes can be described as "competitive." The use of the term "competitive" to describe the payphone industry is correct, we believe, as long as the use of the term clearly indicates that this competition is of the type that renders the monopoly price, not the competitive price. Considering the public statements of numerous payphone operators, we seem to be in agreement with the payphone industry on this point. For example, consider the descriptions of competition in the industry by payphone operators. When the local exchange companies were "... faced with competition from independent public payphone companies ...", People Telephone asserts that the LECs "... increased their compensation arrangements with property owners by offering more favorable commission schedules and other incentives."[11] Just as we have described, competition in the payphone industry forced the LECs to increase their bid to premise owners for the exclusive right to serve. How were these higher commissions funded? Higher rates for consumers, just like we described in our example. The stated rationale for Bell Atlantic's increase of payphone coin rates from $0.25 to $0.35 in November 1997 was that it "must pay competitive commissions for property owners to place its pay phones in their businesses so it must charge a competitive price to users of those phones."[12] Likewise, USWest blamed rate increases across its seven state region to 35 cents from 25 cents on the need to pay competitive commissions to location owners.[13]

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[11] Annual Report Pursuant to Section 13 or 15 (D) of the Securities Exchange Act of 1934, Form 10-K for Peoples Telephone Company Inc., U. S. Securities and Exchange Commission, Washington, D. C. (March 31, 1998), p. 11 ("Peoples 10-K").

[12] See "Bell Atlantic Ups Pay Phone Rates in 9 Areas," Reuters, November 12, 1997. A recent report by the Yankee Group also concludes that payphone competition in the U.S. forced rates to go up. These high rates were, in part, attributed to the high commissions paid to premise owners possible given the lack of competition in the industry (Communications Canada, June 1, 1998, p. 8).

[13] Communications Daily, May 11, 1998. "GTE joined other LECs in boosting payphone rates in Cal. to 35 cents on 40,000 phones in state. Bell Atlantic and SBC also have raised rates, now that

The rate increasing properties of locational monopoly in the payphone industry are not restricted to the local coin rate. Since private payphone operators are allowed to choose the primary long distance provider at each payphone and share in the long distance revenues generated, payphone providers are inclined to choose a long distance provider willing to charge excessive, and in some cases exorbitant, rates for long distance services. These high prices generate revenues that the payphone operator can use to fund commissions, i.e., locational rent. For example, Oncor Communications, a provider of long distance service to about one million payphones and hotel rooms, claimed its high rates for long distance services (nearly $2 per minute) were necessary due to the excessive commissions it had to pay payphone operators and hotels.[14]

Locational monopoly has also affected the rates for information services. In addition to raising the local coin rate to $0.35, BellSouth has also increased the rate for directory assistance to "a market-based rate" of $0.50.[15] One independent payphone operator in the BellSouth region is less certain that this price is the "market-based" (i.e., monopoly) price. In response to BellSouth's announcement, Southern Payphone, Inc. stated that it "didn't know if [the] company would charge 50 cents per directory call ... The cost of that call is so minimal." The Company estimates it costs companies two to three cents to provide the information.[16]

The commissions paid to premise owners are not small. According to public documents filed by Peoples Telephone, commissions payments per payphone average about $62 per month, in excess of one-quarter of the average monthly revenue per phone ($280). In fact, commission payments exceed the monthly cost for LEC Line Service.[17] Payphones Plus, a smaller payphone operator, reports that commissions vary "... from 0% to 50% depending on what the phone brings in for coin and non-coin revenue."[18] Since these commissions are simply a

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FCC has deregulated payphone business to permit market-based rates (Warren's Telecom Regulation Monitor, November 24, 1997). "

[14] See, "FCC Orders Carrier to Lower Rates," Telecommunications Alert, Vol. 12, April 28, 1995.

[15] "BellSouth Ups Quarter Pay Phone Calls," Newsbytes News Network, October 29, 1997.

[16] "BellSouth pay phone rates rise Calls now 35, information 50," The Florida Times-Union, November 1, 1997.

[17] See People's Reply Comments, at 18 and Peoples 10-K, p. 21.

[18] The Guide to Payphone Ownership, Madison: Payphones Plus, 1996, p. 56.

markup of price over economic cost, i.e., supracompetitive profit, the claims of the payphone operators (and the Commission) that (welfare improving) competition is present in the payphone industry are easily dismissed.

## 2. THE GEOGRAPHIC SCOPE OF THE PAYPHONE MARKET

Our characterization of payphone sites as locational monopolies assumes that consumers do not consider alternative payphone sites, whether nearby or otherwise, good substitutes. The evidence presented in the preceding section regarding the effects of competition on commissions and prices is probably sufficient evidence that this assertion is true. In order to evaluate further this issue of demand substitutability and locational monopoly in the payphone industry, we consider the issues of locational monopoly using a popular approach to market delineation -- the Department of Justice's *Merger Guidelines* approach. The Commission itself has used this test in its consideration of both the degree of competition in markets and in merger analysis. The approach has been applied in virtually every industry regulated by the Commission - with the exception of payphones -- including local exchange markets, domestic and international long distance markets, domestic and international satellite markets, cable television markets, broadcast radio and television markets, and wireless markets.[19] Consistent with Commission precedent, we employ this approach in considering the nature of competition in the payphone industry.

According to the Justice Department's *Merger Guidelines*:

> A market is defined as a product or group of products and a geographic area in which it is produced or sold such that a hypothetical profit-maximizing firm, not subject to price regulation, that was the only present and future producer or seller of those products in that area likely would impose at least a "small but significant and nontransitory" increase in price, assuming the terms of sale of all other products are held constant (U. S. Department of Justice and Federal Trade Commission 1992).

As a general matter, establishing a market calls for finding that set of products and producers such that a hypothetical profit-maximizing monopolist (or cartel) could profitably and optimally increase price by five to ten percent for at least

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[19] The *Merger Guidelines* approach is deeply rooted in the Structure-Conduct-Performance paradigm of modern Industrial Organization economics. See, for example Stephen Martin, Industrial Economics: Economic Analysis and Public Policy, New York: Macmillan, 1988, and Gregory J. Werden, "The History of Antitrust Market Delineation," Marquette Law Review, Vol. 76 (1992), pp. 123-215. The approach is flexible and the market definition algorithm useful for many purposes of which merger analysis is just one.

one year. Market definition is accomplished, in practice, by expanding the number of products and number of suppliers until the "product/geographic group" passes a hypothetical monopolist test. Passing the test means that the hypothetical monopolist would and could raise price by ten percent. The independent investigator, in order to determine the properly defined antitrust market, should add to the product group the next-best substitute for the product in question or add the geographic location from which production is the next-best substitute for the production in question. Iterations of the price increase test will be performed successively until sufficient competitive presence is included in the hypothetical monopoly group to make the price increase profitable. The relevant antitrust market is (generally) considered by the investigating agency to be the smallest group of products or group of geographic locations satisfying the test.

In a variety of public pronouncements, payphone operators have pointed to two factors they argue provide competitive checks on payphone prices: cellular phone competition and geographic competition by other payphones. Although these claims are inherently an empirical question, no empirical evidence on these claims is available. However, on logical grounds, these arguments appear dubious.

The degree to which cellular phones could serve as competition for payphones is uncertain at best. First, cellular services are presubscribed, and only those signing up in advance, and who are willing to pay the relatively high costs of such services, enjoy the cellular option. Realistically almost no one makes a decision, on the margin, about whether a given call should be on a cellular phone or a payphone. Applying the accepted antitrust criteria discussed above, would a consumer who had cellular service use a payphone for a given call if the coin rate were $0.25, but switch to the cellular phone if it were $0.30? Thus, subscription to a cellular service probably does reduce the subscribed consumer's use of payphones, but this occurs in the same sense that having a airplane ticket makes one less unlikely to take a bus. An antitrust analysis of either the airline or bus industries might recognize the substitutability of the two transportation services, but would not likely find them in the same antitrust market. This analogy seems even more apt when one recognizes that the economic circumstances of many cellular phone subscribers probably differ substantially from those faced by most payphone patrons.

The necessity of subscription, combined with the high costs of cellular service and low penetration rates in many areas and among many consumer groups, suggest that cellular users are coincidentally "opting out" of any reliance on payphone services when they select cellular service. If cell phones and

payphones were in the same market, we could ask this hypothetical question: how much cheaper would payphones have to be to induce cellular users, such as salesmen or real estate agents, to switch to payphones for their calling? This seems a very unlikely scenario, and one concludes that cellular and payphone services are in different markets.

Payphone substitutability with other payphone sites is also of questionable significance. Using the *Guidelines* approach, the geographic market encompasses the area a consumer would travel to avoid a ten-percent increase in price. It hardly seems reasonable to expect a consumer to search for a nearby payphone, uncertain as to its location and rates, for a price difference of a few cents. Even an increase from $0.25 to $0.35, a forty-percent increase, would hardly drive a customer to incur the search cost necessary to find a proximate, and cheaper, payphone. [20] Finally, that a *few* consumers will be willing to walk away from a high priced payphone -- either looking for another payphone, abandoning the call, or to walking to the nearest cell phone dealer -- is more consistent with the presence of locational monopoly than its absence. Economic theory indicates that the primary consequence of monopoly power is a reduction in output.

Though it is tempting to discount this market analysis given the relatively small absolute price increases, the aggregate social welfare loss of a $0.10 monopoly price increase (say $0.25 to $0.35) is non-trivial. At two million payphones and an average of say 600 local calls per month, the annual transfer from consumers to payphone operators (and then to premise owners) would be $1.44 Billion. Assuming half of the calls made cost $0.50 due to a failure of the payphone to render change, the aggregate transfer would increase to $2.52 Billion.

Furthermore, the ten-percent price increase typically employed by the *Guidelines* approach pales in comparison to the recent forty-percent price hike for a local call in most states ($0.25 to $0.35 per call). This substantial, and sustained

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[20] Even news reports of the impact of deregulation of coin rates (in 1997) and the conduct of the payphone industry reflect the monopoly characteristic of location in the industry. A report in the *Washington Post* argued that "The money you put in [into the payphone] is split between the pay phone company and the owners of the restaurant, bar, hotel, shopping mall or other facility where it's installed. Those establishments typically negotiate among several competing pay phone providers to get the highest possible commission. Commission typically run about 30 percent, or $60 out of a [average] $200 monthly take from a single phone. But competition for proprietors does not mean competition for the calling public: When people need a pay phone, they usually don't shop among several choices, they just go to the nearest one" (see Mike Mills, "Pay Phone Companies Allowed to Raise Prices: No Immediate Increases Expected Locally," Washington Post, October 7, 1997, p. D03).

price increase supports the contention that locational monopoly is prevalent in the payphone industry (if not evidence of cartel behavior). There is no evidence that the price increases have reduced the profits of (or commissions paid by) payphone operators or that the increase will be revoked in the near future.[21] The ability to raise price at nearly every existing payphone location - locations that are, by definition, already profitable -- by forty-percent clearly indicates that individual payphone sites are geographic markets. Considering the fact that most payphones do not render change, the price increase for a large percentage of calls can be as high as 100 percent. Further, it is difficult to rectify the failure of payphones to render change with the presence of competition in that industry or any meaningful consideration of the desires of customers.

## II. Competition, Compensation, and the Coin Rate

The observed coin rates are an inappropriate starting point for the calculation of dial around per call compensation rates for many reasons. As described in the previous sections, the payphone industry, given current technology and business practices, is not a competitive industry in the ordinary sense.[22] The existence of very strong locational monopoly elements, and the strong and ongoing incentives of site owners to maintain these profitable monopoly conditions, implies that observed coin prices reflect exploitation of profitable sites, rather than the economic costs of service as in competitive industries. Thus, on the face of it, coin prices cannot be a credible basis for calculating dial around compensation levels.

On the surface, use of coin rates to support an avoided cost calculation for dial around service seems attractive, though deceptively so. Proponents of this approach can point to relatively free entry into payphone services, and the large

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[21] The assertion that a price of $0.25 per local call is below cost is dubious. Only if payphone operators are forced by regulators to install and maintain payphones at that rate will such a claim have any validity.

[22] The Court noted that "[i]n principle, a market-based rate--as opposed to a cost based rate--could satisfy the statutory fair compensation requirement." In other industries, such as the electric and gas utility industries, the use of market-based rate regulation requires the presence of effective competition in the industry. The submission of factual evidence and economic analysis showing the presence of competition and its constraint on rates is typically required. See, e.g., G. William Stafford, "Electric Wholesale Power Sales at Market-Based rates," Energy Law Journal, Vol. 12 (1991), p. 291; George R. Hall, "The Emerging Standard for Market-Based Wholesale Electric Rates," Public Utilities Fortnightly, Vol. 128 (September 1991), p. 15.

numbers of operators of payphones in the United States.[23] However, the tiny geographic market area presumably associated with a payphone suggests that the industry is better characterized as an agglomeration of thousands of "small" franchise monopolies. Such a market structure is not competitive, and it lacks those characteristics of competition that allow welfare maximizing coinless rate calculations to be made.

The most basic logical error committed in using observed coin rates to calculate the economic costs of dial around service are laid bare by a careful elaboration of the assumptions underpinning this approach. The basic template is as follows. First, if the payphone industry is viewed as competitive in the conventional sense of that term, then market forces can be expected to drive prices toward minimal compensatory levels, i.e., long-run economic costs of services. Assuming this has occurred, at least to a workable degree, one could then use market prices as estimates of the relevant economic costs of the underlying services. This identification of prices with economic costs is, of course, the primary reason economists regard competition as efficient. If one then had credible estimation of those costs of payphone operation that are *incremental* to coin call services, one could subtract these costs, prorated over some number of expected calls, to obtain an estimate of the economic costs per call common to both coin and coinless services. Such an approach appears plausible on the surface because, if the assumptions are true, then the resulting prices would imply each group of services pays at least its incremental costs, and no group pays more than its "stand alone" costs, the economic definition of "subsidy free."[24]

Unfortunately, the economic conditions in the payphone industry cannot justify such a procedure. Cost differences between phones will arise primarily from variations in locational rents, with high traffic sites earning greater payments for the right holder. Because site owners wish to maximize their earnings from their location, and because any given payphone does not compete

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[23] According to data filed with the FCC ("Statistics of Telecommunications Common Carriers") there were about 2 million public pay telephones in the 50 states. Approximately 350,000 or 17.5% of the 2 million telephones were independently operated with the remainder operated by the various LECs. (Cited in Peoples 10-K, p. 5). Other estimates place the number of independent providers a bit higher, estimating (in 1997) a total of 2.1 million payphones of which 500,000 provided by approximately 2,000 independents (see Mike Mills, "Pay Phone Companies Allowed to Raise Prices: No Immediate Increases Expected Locally," Washington Post, October 7, 1997, p. D03).

[24] Daniel Spulber, Regulation and Markets, Cambridge: The MIT Press, 1989, provides extensive discussion of subsidization.

with others unless they are nearly contiguous, owners will act to assure monopoly conditions at their sites so all possible rents will be exhausted. Free entry into the payphone industry only increases competition by providers for good sites -- it does not create more good sites. The result of this form of competition is that (i) profits are captured primarily by site owners, and (ii) payphone operators are essentially required to operate in a monopoly fashion in order to generate incomes sufficient to win franchises from site owners.

This analysis clearly implies that coin prices will be driven towards rent maximizing levels. Of course, site rents *are* a cost to the payphone operators. However, like Ricardian land rents, they are *not* an *economic cost*, but a *rent*, i.e., a *transfer* arising from differential "qualities" of a resource in fixed supply. When one uses the coin "price" to initiate an avoided cost calculation, one is starting from a value that includes both a site rent, with some inherent division of the rent between site owner and phone operator, *and* those economic costs arising from using up society's scarce resources to provide phone services.

An additional problem with any coin-price/avoided-cost methodology is made clear in the above discussion. As coin price deregulation matures, one expects to see growing differences in coin prices at different sites. Even now, anecdotal evidence suggests variations in some cases.[25] In one particular instance, a payphone operator attempted to charge $1.75 for a three minute local call.[26] If coin prices are then to be the basis of cost calculations, which coin prices should be used?

Thus, arguments that purport to calculate correct prices for dial around services must, by necessity, rely on *cost* calculations. Because the payphone industry is not competitive in the conventional sense, prices for coin calls will not equal economic costs, and cannot be used in such calculations.

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[25] See "A Pay-Phone Bonanza at Your Expense," Consumer Reports, July 1998, p. 6; "'Freefone' service Rings in New Advertising Sales Era," USA Today, December 9, 1997, p. 10B.; "BellSouth pay phone rates rise Calls now 35, information 50," The Florida Times-Union, November 1, 1997; Congressional testimony of B. G. Havdahl, April 15, 1998, 1998 WL 12760558. "Bell, GTE and the Texas Payphone Association asked the Public Utility Commission to raise the 25-cent price cap to 50 cents ("A Quarter's Not Enough for a Call/Bell is Adding a Dime to Price at Pay Phones," Houston Chronicle, October 18, 1997). "Pay phone rates expected to soar at some sites New rules allowing the phones' owners to charge what they please could lead to fees as high as $1 (The Fort Worth Star-Telegram, October 8, 1997)."

[26] As a result of this action, along with others, the Georgia Public Service Commission forced Metro-tel, a private payphone operator, to remove up to 3,400 payphones from Olympic sites (Independent Pay Phone Operator Loses Contract to Serve Summer Olympics," Communications Daily, July 9, 1996).

## III. Public Interest Standards for Dial Around Compensation Calculations: Some Considerations

The discussions of the last sections illustrate that the use of observed coin rates to calculate prices for dial around services is inappropriate. Rather, considerations of economic efficiency and equity imply that a bottoms-up cost calculation is required. Even in this case, however, there is an economic subtlety in calculating efficient and fair per call compensation rates that must be addressed. To explain this complication, it is necessary to explore in more depth the workings of a locational monopoly market such as payphones. This analysis will lead to the following conclusions:[27]

1. The minimum economic cost of a payphone capable of providing both dial around and coin calls should be calculated;

2. From this cost in (1), subtract all costs attributable ("caused by") coin capability, including costs of the coin equipment, coin collection, vandalism and/or theft prevention measures, and the like. Costs of equipment for other capabilities unnecessary for dial around capability should also be subtracted out.

3. To the minimum joint and common costs calculated in (2), the opportunity cost of the physical space on which the payphone is located should be added if it is above zero.[28] Such costs might actually be negative if a location owner's other business benefits from having a nearby payphone. Locational rents, i.e., monopoly profit, should not be included in the cost calculations.

4. The competitive prices of coin calls and coinless calls should be calculated, and the average quantities of usage associated with these prices should be calculated.[29]

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[27] Note that the companion report, the MCI Payphone Cost Study, follows these guidelines.

[28] If the physical space required for the payphone has an opportunity cost (whether positive or negative), then that cost is an economic cost. In general, we believe the opportunity cost of this space is small enough (or possibly negative) so that the assumption of zero opportunity cost is reasonable.

[29] As we have discussed throughout this report, there is no available evidence on competitive prices and quantities for payphone services. Either regulation or locational monopoly distorts prices, and thus quantities. To more accurately reflect the per call cost of a call, a reasonable attempt to adjust the observed quantities should be made.